BoE Watch

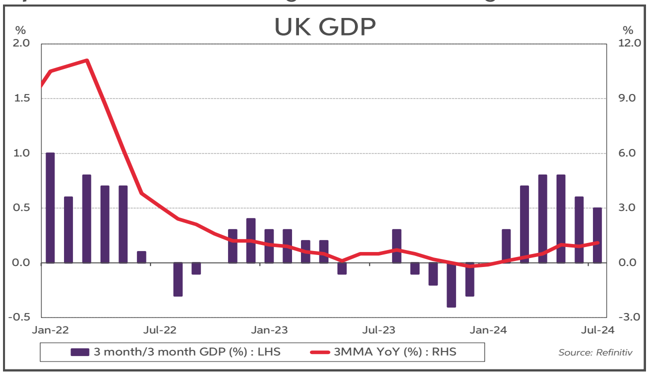
AIB Treasury Economic Research Unit

19th September 2024

No change from BoE, but further easing on the cards

The September meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank leave the Bank rate at 5.00%. This follows a 25bps cut implemented at its previous meeting in early August. The decision to cut in August represented the first rate change from the Bank of England in eight meetings. Prior to that, the central bank had been on a rate tightening cycle over the period December'21 to August'23. Meanwhile, as part of its annual review of its stock of UK government bonds on its balance sheet (arising from previous QE initiatives), the BoE announced today that it would continue its quantitative tightening at a pace of £100bn over the next year.

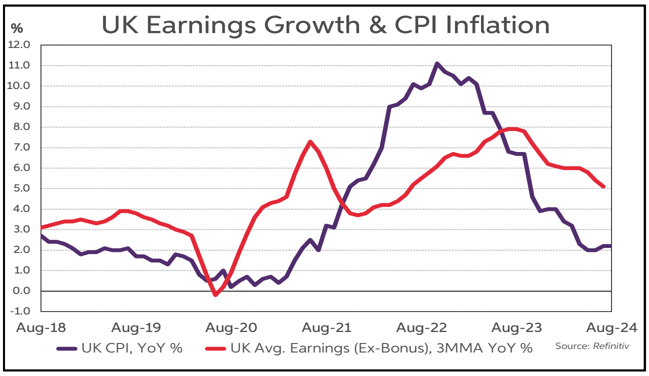
Today's 'hold' on rates from the BoE was very much in line with expectations, with the August rate cut being such a close call (vote was 5:4), and given there was no guidance from the BoE in the lead up to today's meeting on the potential for a rate cut this month. Once again, there was no unanimity within the BoE on their rate decision. The vote was 8:1 in favour of no change. For the 'eight', they concurred that the current stance of monetary policy "was appropriate" and it was likely a "gradual approach" to lowering interest rates would be warranted**.** One member (Dhingra) preferred a 25bps rate cut. Their view was that the Bank rate needed to "become less restrictive now to enable a smooth and gradual transition in the policy stance and to account for lags in transmission".



The meeting statement noted that there has been "limited news in UK economic indicators" since its last meeting in August. This meeting was when the BoE outlined its updated set of macro forecasts with the publication of the quarterly Monetary Policy Report (MPR). In terms of its growth outlook, the BoE revised higher its near term growth expectation. It is forecasting GDP growth of 1.25% for this year. This compares to its previous forecast for 0.5%. The upward revision was due to the BoE taking on board that year-to-date growth has been stronger than it previously envisaged. Meanwhile, for 2025 and 2026, it left its GDP projections unchanged at 1% and 1.25% respectively. Overall, this set of GDP projections still represent a relatively weak growth outlook for the UK economy.

On the inflation front, the August MPR forecasts showed that the BoE anticipated that the CPI rate will end this year at 2.75%, with the acceleration in inflation arising from the unwinding of energy related base effects. It continues to expect that inflation will ease to 2.25% by the end of 2025. It also maintained its end-2026 forecast for inflation at 1.5%. Today's minutes though indicate that the BoE now anticipates inflation to only increase to around 2.5% towards the end of this year.

With no rate change envisaged from the BoE today, the focus was on what guidance, if any, would be forthcoming in terms of the outlook for the Bank rate over the coming months. The BoE continues to state that policy will need to remain "restrictive for sufficiently long" until the risks to inflation returning sustainably to its 2% target have "dissipated further". It also continues to guide that it will take a meeting-by-meeting approach to any additional changes to interest rates. The BoE did though add to its concluding statement paragraph that "in the absence of material developments, a gradual approach to removing policy restraint remains appropriate". In addition to this, Governor Bailey stated that the easing in inflation pressures meant the BoE should be able to cut rates gradually over the coming months. At the same time he noted "But its vital that inflation stays low, so we need to be careful not to cut too fast or by too much".



Futures contracts suggest the market is leaning towards a further 50bps of rate cuts over the remaining two meetings of 2024 (Nov 7th, Dec 19th). Given the BoE's next meeting in November corresponds with the publication of their updated macro forecasts, it is reasonable to anticipate a 25bps rate cut then, as it would be consistent with their "gradual approach" to easing policy. We continue to expect the Bank rate it to end the year at 4.50%.

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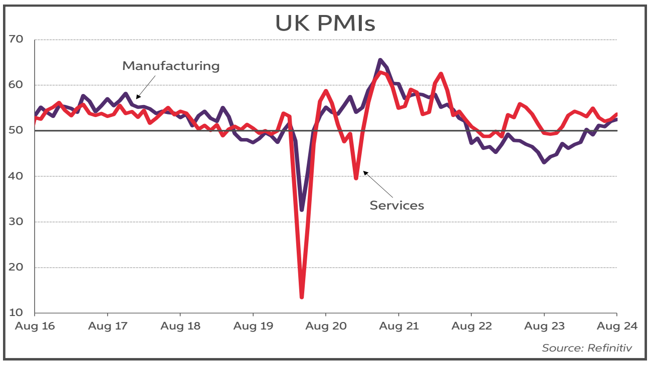
Economy gains momentum but outlook still challenging

The UK economy gathered some momentum in the first half of the year, with GDP rising by 0.7% in Q1 and by 0.6% in Q2. The underlying breakdown for Q2 showed household consumption rose by 0.2% in the quarter, contributing 0.1 percentage points (p.p.) to growth. Meanwhile, gross fixed capital formation added a hefty 2.4 p.p. to the total, owing to increases in fixed investment, and a sharp rise in inventories. Government expenditure boosted output by a further 0.3 p.p.. Imports expanded at a faster pace than exports (+7.7% vs. +0.8% q/q) meaning net trade clipped 2.2 p.p. from GDP.

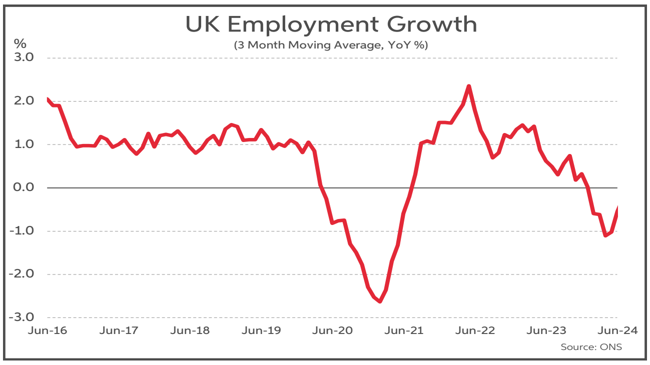
However, the available hard data for Q3 have been mixed. The monthly reading of GDP stagnated in July for a second consecutive month, as falls in activity in the manufacturing and construction sectors acted as headwinds to growth. Meanwhile, industrial production remains volatile, contracting by 0.8% m/m in July, erasing the 0.8% m/m increase in June. Elsewhere, retail sales rose by 0.5% in July, leaving them 1.4% higher in year-on-year terms.



In contrast, survey data indicate the economy continued to expand at a solid pace in Q3. The services PMI remained firmly in expansion mode and increased to 52.4 in July, and to 53.3 in August. Similarly, the manufacturing PMI rose to 51.8 in July and to 52.5 in August. The data are consistent with activity in both sectors rising at an accelerating rate so far in Q3. Consumer confidence has also continued to improve, rising to it highest level since September 2021 in July, at –13.0, and staying at that level in August.

In terms of the labour market, there were clear signs of softening in the first five months of the year. More recently though, conditions appear to have tightened once again. The unemployment rate increased steadily from 3.8% in December to 4.4% in April and May. Furthermore, the number of people in employment had fallen by 108k by the end of April. However, the unemployment rate has declined to 4.1% in July, while the employment level rose by 233k between May and June. At the same time, average earnings growth has cooled, but it remains elevated at +5.1% y/y in the three months to July. The Indeed wage tracker data also indicates that earnings pressures are robust, with wages up by 6.7% y/y in the three months to August, albeit this figure is inflated by a chunky one-off rise in the minimum wage. However, other measures of wage inflation continue to point to lower and more stable earnings growth. The BoE Agent's Summary Survey for Q3 noted that pay settlements are likely to average 5.5% this year, but they are expected to fall to 2-4% in 2025.

On the inflation front, headline CPI fell to 2% in May and stayed there in June, reaching the target for the first time since July 2021. However, it rose slightly to 2.2% in July and remained at that rate in August. Furthermore core-CPI is still quite sticky, rising to 3.6% in August from 3.3% previously. Services inflation remains very high and is a key area of concern for the BoE, running at 5.6% in August. Looking ahead, the BoE expects headline inflation will continue to rise, reaching 2.75% in Q4 2024, before easing to 2.25% by Q4 2025.



Overall, the UK economy has gathered some impetus this year as inflation has eased, paving the way for real income growth. Increased political stability following the recent election and the BoE's decision to cut rates in August have also provided a supportive backdrop. **However, the UK economy faces a number of challenges.** Most pressing, the Government has little scope for major reforms in the upcoming Budget, given the tight fiscal rules it has committed to adhering to. Longer-term productivity growth, which has been dire since the Global Financial Crisis, will need to rise. A bout of political stability may support business investment, but a sustained rise in productivity may only be achieved by making difficult reforms to the planning system and tax code. **The outlook for UK growth remains subdued.** The IMF is forecasting that UK GDP will rise by just 0.7% this year. Growth is expected to accelerate to around 1.5% in 2025. Meanwhile, the August Monetary Policy Report shows the BoE sees the economy expanding by 1.25% in 2024 and by 1% in 2025.

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